International Monetary and Financial Committee

Ninth Meeting
April 24, 2004

**Statement by Gerrit Zalm, Minister of Finance of the Netherlands,
Representing the constituency consisting of Armenia, Bosnia and Herzegovina,
Bulgaria, Croatia, Cyprus, Georgia, Israel, Republic of Macedonia, Moldova, the
Netherlands, Romania, and Ukraine**

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The concentration of Fund credit on a few large debtor countries has increased to heights last seen in the 60s and 70s (the three largest debtors Brazil, Turkey, and Argentina now account for about 70% of the outstanding credit under the General Resource Account). Contrary to the situation in the 60s and 70s, the Fund-supported programs to these large debtor countries all involve exceptional access. Reducing the need for large Fund credits would be beneficial for both member states and the Fund. In this context some issues on the agenda of this IMFC meeting deserve special attention, which will be elaborated on below.

Effective crisis prevention is the best way to reduce the need for large Fund credits. Therefore, the Fund continuously strives to strengthen its surveillance instruments. In this light, my constituency welcomes the use of debt sustainability analysis and the balance sheet approach; presumed publication of Article IV reports; and factoring the implementation of past surveillance advice into program discussions. Besides that, precautionary or low access arrangements can be useful instruments to provide a positive signal to markets (and/or donors) without necessarily drawing substantially on Fund credit and adding to the member states' debt burden (see section 2). A further way to reduce the need for large Fund credits is to strongly encourage private sector involvement when resolving balance of payments crises. This can be accomplished by strictly adhering to the IMF's exceptional access framework and improving relations between debtor countries and private creditors for example through a Code of Good Conduct (section 3). On a smaller scale, in the case of low-income countries the recently developed debt sustainability framework underscores that IMF financing should, where possible, be kept to a minimum. The ultimate aim of such financing should be graduation from a program-based relation to a surveillance-based relation. Low access PRGFs could be a valuable instrument, also to exit a program relation and keep IMF financing limited (section 4).

1. World Economic Outlook: tackling global imbalances together

The recovery of the world economy has gathered steam over the past few months. The **short-term economic outlook is fairly benign.** Economic growth has rebounded forcefully in the United States, while prospects for the Japanese economy have also significantly improved. In the euro area, economic recovery proceeds at a slower pace. The good growth prospects for the other countries in my constituency, with GDP growth forecasts for 2004 ranging between 2.5% (Israel) and 9.5% (Ukraine), are noteworthy.

Global imbalances remain an important downward risk for the world economy. A disorderly adjustment of these imbalances would jeopardize further economic recovery. Rather, a gradual correction is desirable. As the global imbalances reflect many different factors, adjustment should take place through different channels:

- Fixed exchange rate policies of some Asian countries appear to have prevented the dollar from depreciating more in effective terms. **More exchange rate flexibility in Asia may help to reduce the risk of domestic imbalances while reducing global current account imbalances and spreading the adjustment burden more evenly across regions. This should be a *gradual* process, requiring a sufficiently strong and well regulated domestic financial system, in order to ensure an orderly adjustment**. Given the relevance of this issue to the Fund's mandate as well as the IMF staff's expertise, we invite the Fund to undertake a study on the possible options for introducing more exchange rate flexibility while safeguarding macro-stability in these countries undergoing rapid economic and structural change.
- Reducing external imbalances also requires that **internal imbalances are addressed**. Given its size, this holds in particular for the United States, where the government budget should improve over the course of economic recovery while discretionary fiscal measures may also be needed to reduce government spending.
- **Growth prospects outside the United States – particularly in Europe – should improve**, reflecting the continued need for structural reforms in some countries. In some areas, the corporate sector in Europe faces relatively strictly regulated labour and product markets. This limits the pace at which cost cutting measures can be implemented and – related – debt levels can be reduced during an economic downturn. This underscores the need to increase the flexibility of product and labour markets. Moreover, I would like to point out that policymakers can also contribute to lower costs by alleviating the corporate sector's administrative burden. From a longer term perspective, initiatives to deregulate markets and increase labour productivity and participation are of crucial importance to address the challenges posed by ageing populations. In light of the above, I very much welcome the illuminating WEO-chapter on the economic and political factors affecting the structural reform agenda. As the Fund indicates, there is often a friction between short-term pain and long-term gain, but the lasting benefits should prevail.

There are other downward risks as well, particularly for financial markets. Better economic performance will sooner or later cause upward pressure on interest rates, which are still historically low. As the ‘search for yield’ effect would disappear, interest rate increases could be particularly pronounced in emerging economies, as spreads are likely to rise. This is especially relevant for Latin American emerging markets, several of which are among the largest users of Fund credit, reflecting their still fragile economic prospects. Sovereign spreads in these markets have recently reached (historical) lows, also reflecting the benign economic environment. It should be noted that Brazil has made strong policy adjustments. These have increased business confidence, pushed down domestic interest rates and laid the foundation for a sustainable recovery. While the Argentine recovery has also been favourable, several policy issues need to be resolved. The need to increase the pace of fiscal consolidation and make progress in debt restructuring negotiations with the private sector is particularly large.

2. Surveillance and crisis prevention: making good use of Fund advice

My constituency looks forward to the 2004 Biennual Surveillance Review and welcomes the initiatives currently being worked out to strengthen surveillance. In order to further improve the quality and effectiveness of the surveillance process, we emphasize three issues:

First, my constituency urges an increasing use of debt sustainability analyses and the balance sheet approach in Article IV consultation reports. With regard to the debt sustainability analyses, in addition to the baseline policy scenario, plausible alternative policy scenarios should be included. Furthermore, we welcome the pilot project to include cross-sectoral balance sheet analysis of vulnerabilities in future Article IV reports. After the reports on Thailand and Peru, we look forward to the analyses in the Board papers on Turkey and Lebanon, among others. In choosing members for the pilot, the focus should be on those countries likely to benefit the most from this approach, for example emerging markets. We support the Fund in using the insights of the balance sheet approach and debt sustainability analyses in providing guidance to staff on setting debt limits in Fund-supported programs. Cross-country balance sheet issues should be included in the World Economic Outlook.

Second, my constituency encourages the Fund to enhance the effectiveness and impact of surveillance, especially also in non-program settings. In this respect, we welcome the Board decision to move towards presumed publication of Article IV reports as of July 2004. All countries in my constituency publish their Article IV reports as well as program documents. Moreover, Article IV reports should also indicate to what extent national authorities have taken into account earlier Fund advice, also taking into consideration whether this advice was appropriate. **Also, the extent to which member states have followed up on earlier Fund advice could be factored into program discussions. Member states that have neglected sound policy advice and consequently run into balance of payments problems should have an especially convincing program.** Finally, the surveillance process could be used to identify more explicitly possible needs for technical assistance and to reflect on the use of earlier technical assistance. All these suggestions will not only increase the ‘bite’ of surveillance, but also foster the accountability of the IMF in delivering clear, appropriate, and high quality advice.

Third, my constituency believes an important aspect of Fund involvement in member states is the signalling function towards financial markets and donors. While surveillance is often considered a relatively light signal, Fund programs provide for a strong signal on the basis of their conditionality. **In this context, we believe precautionary arrangements can provide such a strong signal, given the arrangement’s upper credit level conditionality, without necessarily leading to Fund financing.** Given the overall positive experience with low-access precautionary arrangements in emerging market economies to date, further guidance could be given to staff on promoting the use of such arrangements (where applicable) in its dialogues with national authorities, particularly as an alternative to conventional program relationships and as part of an exit strategy from Fund resources.

According to my constituency, (additional) access under precautionary arrangements should generally be low and in any case remain within normal access limits. The use of ex ante exceptional access precautionary arrangements would raise serious questions on moral hazard and the compatibility with the exceptional access framework. Indeed, high access would make no sense, as there would be no initial balance of payment need nor an intention or evident need to draw on the financial resources of the Fund. In the end, the presence of a program, including its conditionality, should be more important than its size. In the event a (capital account) crisis nonetheless erupts and a large acute borrowing requirement emerges, the existing arrangement could be readily augmented and turned into a regular Supplemental Reserve Facility arrangement with higher access as well as appropriate conditionality, preferably including private sector involvement. For member states that already have high or exceptional access to Fund resources, a strict upper bound for additional precautionary access is desirable. Such a limit could in each case be formed by the most binding of the following two constraints: 1) a standard annual limit of 100 percent of quota per year; or 2) a precautionary access level that would preclude a further rise in total Fund exposure to the country. Which of these two constraints is most binding depends on the profile of repurchases.

3. Crisis resolution: ensuring official and private financing sources

The large exceptional access granted to the three largest borrowers from the Fund results in a high level of concentration of IMF credit. Also, recent experience shows that balance of payments problems in exceptional access cases tend to exceed the regular program horizon. These two developments potentially pose risks to the Fund's financial position and underscore that quick and orderly resolution of balance of payments crises continues to deserve our full attention.

In order to address these issues, **our constituency first of all calls for strict adherence to the IMF's exceptional access framework.** Besides limiting the number of cases of exceptional access to Fund's financial resources, this also remains essential to increase the involvement of the private sector in crisis resolution. A strict access policy can also limit moral hazard and will ensure equal treatment of member states. Exceptional access should remain exceptional and not become a standard feature of Fund programs. Therefore, the burden of proof lies with those who argue in favour of exceptional access.

To promote orderly relations between debtor countries and private creditors, and thereby preventing crises of confidence, **my constituency encourages representatives of leading debtor countries and private creditors to agree on a Code of Good Conduct.** The code should establish a number of general, non-binding principles and guidelines regarding the exchange of information between debtor and private creditor, comparable inter-creditor treatment, and decision mechanisms in case of debt restructurings. The Fund could also encourage the implementation of elements of a Code by individual member states in its surveillance activities, and take note of a good standing relationship with private creditors of a member state in program decisions.

Occasionally, member states seek Fund support while they are in arrears with private creditors. As a precondition to IMF support, the Fund demands from these members that they make a strong effort to resolve the arrears. This precondition serves as a financial assurance to the Fund's resources, as it strives to bring about a quick return to sovereign debt sustainability and the restoration of access to sources of private financing. As such, the Fund's Lending Into Arrears (LIA) policy indirectly fosters the process of debt restructuring negotiations. **In my constituency's view, the current LIA policy needs further elaboration** in this respect. One way forward would be to further clarify the criteria that guide the assessment of 'good faith' behaviour, for example by introducing threshold values for the representativeness of creditor committees, and by specifying the concepts of constructive dialogue and negotiation (e.g. setting up a draft timetable for debt reconstruction negotiations). **Moreover, the Executive Board should be involved in the assessment of a member state's compliance with the LIA framework on a timely basis by discussing a special report, similar to the reports on exceptional access**. In these reports, the criteria of the LIA framework should be strictly applied to the specific country case, especially regarding 'good faith'.

Closely related to the development of the Code and the strengthening of the Fund's lending into arrears policy, my constituency also invites the Fund to elaborate on issues such as aggregation of claims and the treatment of existing debt stock that may lack Collective Action Clauses (CACs). Moreover, it is encouraging that more than three quarters of the total value of recently issued sovereign bonds include CACs. A large number of countries have set an example in this respect. My constituency encourages all countries to follow this example and include CACs (preferably in accordance with the G10 recommendations) in international sovereign bonds and encourages the Fund to monitor the use of CACs in its surveillance activities. Progress in these fields will facilitate a better coordination between debtor countries and private creditors, and can be a catalyst for the development of the Code of Good Conduct and the elaboration of the criteria of the LIA framework.

As the high exposure of the Fund to a limited number of member states potentially poses risks to the financial position of the Fund, our constituency reaffirms the importance of the preferred creditor status of the Fund. This status is key to preserving the revolving nature of the Fund's resources. Our constituency encourages the IMFC to reaffirm the preferred creditor status in its press communiqué.

4. The role of the IMF in low-income countries: a tailor-made approach

My constituency encourages the IMF to continue the valuable discussion on the fundamental role the Fund has to play in low-income countries. In this respect, we wish to reiterate three key principles:

- **The Fund's relationship with low income countries is aimed at establishing macroeconomic stability, as this fosters economic growth and poverty reduction.** However, given the deep-seated, possibly micro-based, problems that cause macroeconomic instability, the Fund's engagement with low-income countries is generally long-term, and might include institution building in public finances, monetary policy and the financial sector. Whereas the Fund should use its instruments - surveillance, program lending and technical assistance – to assist these countries in building an environment conducive to sustainable economic growth and poverty reduction, other development partners (particularly the World Bank) should concentrate on structural economic adjustments. All these efforts should be aligned to the development objectives as formulated by the member state in its PRSP.
- **The recognition of such a relationship should not be confused with IMF financing being provided over longer periods.** Although the Fund's role in providing temporary financial support to foster macroeconomic stability may often remain indispensable, the Fund should focus on its advisory role, also in terms of technical assistance for capacity building and institutional strengthening, and its signaling function towards other development partners and financial markets. Long-term financial assistance should preferably be provided by others.
- **The crucial issue is to tailor the mix of IMF policies as well as instruments to a country's political and economic realities.** There is no such thing as a one-mix-fits-all. If the balance between knowledge and finance is generally tilted towards the former, the risk of countries

becoming unnecessarily long users of Fund credit will be mitigated. Indeed, the ultimate aim should be to facilitate a graduation from a program-based relation to a surveillance-based relation.

My constituency welcomes that the dimension of debt sustainability features prominently in this discussion. The recently developed debt sustainability framework - as well as the scarcity of the Fund's concessional resources - underscore that IMF financing should, where possible, be kept to a minimum, while new donor money should be provided on a highly concessional or grant basis. In this respect, we believe that the Fund as the global institution dealing with balance of payments pressures should play a facilitating role in resource mobilization, for example during consultative group meetings. This will promote that external funding is consistent with a country's repayment capacity.

These considerations imply that **my constituency supports a greater use of low-access PRGF arrangements.** The use of low access programs is particularly feasible in member states that have limited balance of payments pressures and move toward exiting a PRGF program relationship with the Fund. These countries have a need for a seal of approval on macro-oriented policies. In these cases, clear communication is essential: both member states and donors should consider low access as normal in these circumstances and not as a weakness. In case a country is confronted with an exogenous shock, a swift augmentation of access, and if needed conditionality, should be possible. Moreover, low access PRGF-arrangements can play a useful role for countries that cannot afford large Fund borrowing, but need program involvement as an important anchor for the domestic policy framework.

One step further on the road to a surveillance-based relationship, we believe that Post-Program Monitoring (PPM) could be a useful instrument, also given the overall positive experience with this facility in emerging market economies. However, given the emphasis on PRGF-programs with low access, developing counties cannot generally be expected to graduate directly from a large PRGF-program to a surveillance-based relationship with the Fund. Therefore, the current threshold for access to the PPM (100% of quota) might be too high in the context of these countries. We would favour a flexible application of the PPM in which the threshold is tailored to the specific circumstances of low-income countries. Also, the Executive Board should be sufficiently involved. A review of the PPM, taking into account the application in both emerging economies and low-income countries and related procedures, would be welcome, also to secure a constructive dialogue between staff and the authorities. Each stage of a program relationship should be complemented by surveillance and technical assistance. The coherence between the latter two policies could be strengthened. Indeed, surveillance can help to identify TA needs as well as provide insight into the results of earlier TA delivery.

My constituency also acknowledges the improved Fund/Bank collaboration. Nevertheless, we believe that a further clarification of roles with regard to especially structural conditionality is still needed. **We suggest operationalizing the lead agency concept by a comprehensive policy table in Bank/Fund documents.** The table should provide an overview of specific structural reforms, their purpose, their timing, and the institution primarily responsible for their monitoring. It would be helpful in managing the totality of conditionality, avoiding undue overlap or gaps in coverage for the country concerned and enabling both institutions to focus on their core mandates. Although my constituency welcomes the intentions of the Fund with regard to Poverty and Social Impact Analysis (PSIA), in our view, the World Bank is the lead-agency on PSIA. However, we acknowledge that it is very important the Fund is sensitive to the implications of the macro-oriented measures it proposes. Also, country ownership of reforms could be improved by informing the national debate on reform design, the trade-offs between policy choices, and final decision making. In addition to close contacts with the World Bank, my constituency encourages the IMF to enhance consultations with officials of low-income countries, regional multilateral development banks, bilateral donors, and civil society organizations.

5. Other issues

- We encourage all countries to continue their efforts to ensure the consistent application of measures against the financing of terrorism and money laundering (AML/CFT). My constituency welcomes the preliminary outcome of the 12-month pilot program in which the IMF and the World Bank have successfully applied the FATF's recommendations in the assessment of countries' financial systems. My constituency supports an integrated approach to AML/CFT assessments in close cooperation with the FATF. The Fund should closely monitor the budgetary impact of this additional task.
- In winding up this intervention, my constituency would like to draw attention to the Fund itself and its staff. Over the recent years, the IMF has weathered a number of major international storms. As a result of this turbulent environment, and as a reflection of the good achievements of the institution itself, more and more tasks have been added to the Fund's mandate. At the same time, the IMF's budget has come under pressure. While this process is understandable, my constituency believes that we should also not lose sight of protecting the institution itself. This calls for a clear prioritization when it comes to the activities of the Fund, also in light of the staff's workload. My constituency would like to suggest paying attention to the proper consolidation of new tasks in an organization with a clear and coherent mission and with high-quality performance. The strong performance and morale of this institution and its staff should be maintained and enhanced.